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Tax Exempt Corporations - Farmers Co-operative Marketing and Purchasing Associations

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While it is true, as suggested in *Simons v. Kidd, supra,* that N.D. Rev. Code § 28-01261 (Supp. 1949) deals with a part of the same subject matter, namely survival of things in action, as our earlier N.D. Rev. Code § 47-0703 (1943), the two statutes are in no way conflicting and there is no necessity of any repeal or amendment by implication of § 47-0703.

The only necessary effect of the recent enactment is to add to the number of causes of action permitted to survive by the construction given § 47-0703 in *Grabow v. Bergeth.* Thus, a cause of action for damages for a breach of contract could survive under either section while a cause of action for damages for personal injury based on negligence, for example, would survive only by virtue of § 28-01261.

It is submitted that our courts would be justified in assuming that the legislature in enacting the new survival statute intended that it should have no effect on the assignability of causes of action. It would seem that to conclude otherwise would be adding by judicial construction to an unambiguous statute dealing only with survivability.

Thomas D. Butler

TAX EXEMPT CORPORATIONS—FARMERS CO-OPERATIVE MARKETING AND PURCHASING ASSOCIATIONS. Farmers' co-operatives are only one of a group of nineteen categories of organizations which are given tax exemption by the Internal Revenue Code.[1] Their similarity, however, to ordinary commercial corporations and the fact that they compete directly with such corporations has made them a subject of much criticism. Such organizations as the National Tax Equality Association have conducted persistent campaigns to have the exemption ended on the ground that such exemption gives the co-operatives an unfair advantage over corporations subject to tax.[2]

It is not the purpose of this writing to enter into any discussion of whether or not the exemption should be continued. Rather, it is to illustrate the requirements to be met for tax exemption of farmers' co-operatives and the development of the law from the inception of the Income Tax Law in 1913 to the present date. These requirements present a number of difficulties from the standpoint of the co-operative. Indeed, so formidable a barrier have they proved that it was stated recently that only about one half of the farmers' co-operatives in the nation are now tax exempt.[3]

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[1] Int. Rev. Code § 101(12).

[2] Note, 34 Va. L. Rev. 314 (1948).

[3] Treasury Department Document No. 3157 (1948).

Before discussing these requirements, a clarification of just what is a co-operative may be desirable. A co-operative has been defined as an "association which furnishes an economic service without entrepreneur or capital profit and which is owned and controlled on a substantially equal basis by those for whom the association is rendering service."[4] This is only one of many definitions given to co-operative associations and while perhaps not complete, fairly well covers the basic concepts. Theoretically there is no capital profit and the association is owned by those receiving the services. This has not been strictly followed in the case of farmers' co-operatives as we shall see in the development and interpretation of the law.

DEVELOPMENT OF THE REQUIREMENTS FOR TAX EXEMPTION

Farmers' co-operatives are deemed entitled to tax exemption on the theory that they are organized and operated for the benefit of the members. This was the basis upon which the Revenue Act of 1916[5] was originally drafted. It provided exemption to "Farmers', fruit growers', or like associations organized and operated as a sales agent for the purpose of marketing the products of its members and turning back to them the proceeds of sales, less the necessary selling expenses, on the basis of the quantity of the produce furnished by them." It was the purpose of the law to grant exemption to associations which operate on a non-profit basis. The Revenue Act of 1921[6] extended the exemption to purchasing co-operatives by adding ". . . or organized and operated as purchasing agents for the purpose of purchasing supplies and equipment for the use of members and turning over such supplies and equipment to such members at actual cost, plus necessary expenses." Since it is impossible to predict what the costs and expenses will be, co-operatives ordinarily pay market prices for goods they sell for the producer, and charge market prices for goods purchased for the consumer. The excess or profit is then returned, on the basis of business done, in the form of refunds or rebates called patronage dividends. This meets the requirements of the Revenue Acts. Thus, a co-operative association which under the Revenue Act of 1921 did not rebate all the earnings of the association but kept a portion of them in reserve was held non-exempt.[7]

Treasury regulations in 1922 and 1924[8] stated that such exemption was not to be denied if reserves were created for certain purposes—namely, reserves for depreciation or possible losses, reserves required by state statutes, reasonable sinking funds or surplus to provide for erection of buildings and facilities required in the business. Because of the broad interpretation of the early revenue acts

[4] Packel, *What is a Co-operative?* 14 Temp. L.Q. 61 (1939).
[5] Revenue Act of 1916, § 11 (a-11), 39 Stat. 767 (1916).
[6] Revenue Act of 1921, § 231(11), 42 Stat. 253 (1921).
[7] Riverdale Co-operative Creamery Ass'n v. Comm'r of Int. Rev., 48 F.2d 711 (9th Cir. 1931).
[8] U.S. Treas. Reg. 62, § 522 (1922); U.S. Treas. Reg. 65, § 522 (1924).

by the Treasury Department, the Revenue Act of 1926[9] included a provision "... nor shall exemption be denied any such association because there is accumulated and maintained by it a reserve required by State Law or a reasonable reserve for any necessary purpose." Under this provision the requirement that a co-operative association distribute all of its net income is not violated by the retention of reserves where the necessity of such reserves is shown.[10]

The Revenue Act of 1926[11] incorporated a number of other changes and otherwise enlarged on the previous Acts. The requirement that the associations be organized and operated as "sales agent" or "purchasing agent" was deleted in view of the fact that co-operative associations which buy and sell, and take title to farm products in their own names and not as agents were deemed by the treasury department not to lose their exempt status.[12] It enlarged on the previous Revenue Acts by including "or other producers" in paragraph (a) of section 231 (12) and including "or other persons" in paragraph (b) of the same section.[13] This had the effect of allowing farmers' co-operatives to deal with others than members but also had the effect of requiring distributions to the nonmembers as well as members. An association which did not distribute any proceeds to nonmembers was denied exemption.[14] Similarly, a Nebraska association which restricted the right of participation in profits to members was not exempt.[15] Another Nebraska association was denied tax exemption because its by-laws provided that after the establishment of a sinking fund and payment of dividends on capital stock, the remainder of the net earnings was to be divided pro rata among those customers who were members.[16] Also, where a part of the proceeds from nonmembers' products was used by a farmers' co-operative marketing association to create a surplus and to make additions to capital assets of the association, without allowing nonmembers a proportionate distributive interest in permanent value contributed thereby, the association was not exempt from taxation, since to that extent the association was operated for profit to its members, as against nonmem-

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[9] Revenue Act of 1926, § 131 (12), 44 Stat. 40 (1926).

[10] Mim. 3886, X-2 Cum. Bull. 164, 168 (1931).

[11] Revenue Act of 1926, § 231-(12), 44 Stat. 40 (1926).

[12] Mim. 3886, X-2 Cum. Bull. 164 (1931).

[13] Revenue Act of 1926, § 231 (12), 44 Stat. 40 (1926).
growers', or like associations organized and operated on a co-operative basis (a) for the purpose of marketing the products of members *or other producers,* and turning back to them the proceeds of sales, less necessary marketing expenses, on the basis of either the quantity or the value of the produce furnished by them, or (b) for the purpose of purchasing supplies and equipment for the use of members *or other persons,* and turning over such supplies and equipment to them at actual cost, plus necessary expenses . . . ."

[14] Producers' Creamery Co. v. U.S., 55 F.2d 104 (5th Cir. 1932).

[15] Farmers Co-operative Company v. U.S., 23 F. Supp. 123 (Ct. Cl. 1938).

[16] Farmers Union Co-operative Supply Co. v. U.S., 23 F. Supp. 128. (Ct. Cl. 1938).

ber patrons.[17] However, this requirement of equitable distribution to patrons is not violated where the payment of patronage dividends to nonmembers is merely deferred until membership is actually secured by the accumulation of dividends in an amount equal to the purchase price of a share of stock or membership.[18]

The Revenue acts from the earliest provision in 1916 have required co-operatives to turn back the proceeds to members or other producers on the basis of the quantity of produce furnished them. Thus, a distribution of dividends by an association on the basis of stock held rather than on the basis of business done precluded the association from tax exemption.[19]

Co-operative associations are also limited as to the amount of nonmember business. The Revenue Act of 1926[20] provided that "such an association may market the products of nonmembers in an amount the value of which does not exceed the value of the products marketed for members, and may purchase supplies and equipment for nonmembers in an amount the value of which does not exceed the value of the supplies and equipment purchased for members, provided the value of purchases made for persons who are neither members nor producers does not exceed 15 per centum of the value of all purchases." The last part of the above section may be slightly confusing. It means that purchases for nonmembers may not exceed the value of purchases for members, but if the nonmembers are also not producers, then the purchases for them may not exceed 15 per cent of the value of all its purchases.[21] Under this provision farmers' co-operative associations which did business with non-stockholders, the value of which was greater than the value of business done with stockholders, were not entitled to exemption.[22] The Revenue Act of 1934[23] liberalized the above requirement by providing that business done for the United States or any of its agencies shall be disregarded in determining the right to exemption. That is, the limitation on nonmember business is exclusive of business done for the United States or its agencies.

Another limitation of the Revenue Code[24] requires that substantially all of the stock must be owned by producers who market their products or purchase their supplies through the association. Any ownership of stock by nonproducers must be explained; it must be shown that stock ownership has been restricted as far as possible to pro-

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17 Fertile Co-operative Dairy Association v. Houston, 119 F.2d 274 (8th Cir. 1941).
18 Mim. 3886, X-2 Cum. Bull. 164, 166 (1931).
19 Producers Creamery Co. v. U.S., 55 F.2d 104 (5th Cir. 1932).
20 Revenue Act of 1926, § 231(12), 44 Stat. 40 (1926).
21 Mim. 3886, X-2 Cum. Bull. 164, 168 (1931).
22 Producers Livestock Mk't'g Ass'n v. Comm'r of Int. Rev., 45 B.T.A. 325 (1941).
23 Revenue Act of 1934, § 101(12), 48 Stat. 701 (1934).
24 Int. Rev. Code § 101(12).

ducers.[25] If by statutory requirement officers must be shareholders, ownership of a share of stock by a nonproducer to qualify him as an officer will not destroy the exemption; or if a shareholder ceases to be a producer and the association cannot purchase or retire his stock, under such circumstances, ownership of a small amount of the outstanding stock by nonproducer shareholders will not destroy the exemption.[26] Where a substantial part of the stock was voluntarily sold to nonproducers, exemption must be denied as long as such stock is so held.[27] The restriction does not apply to nonvoting preferred stock provided the owners of such stock are not entitled to participate in the profits of the association upon dissolution or otherwise, except to the extent of the fixed dividend.[28]

Although a co-operative is an association which furnishes an economic service without entrepreneur or capital profit, it may nevertheless pay dividends on capital stock without losing its exemption. However, the dividend rate of such stock is limited to the legal rate of interest in the state of incorporation or 8 per cent per annum, whichever is greater.[29] Illustrating this requirement is a 1931 case which denies exemption where before earnings were refunded to members on the basis of produce sold for them, 10 per cent dividends were paid on capital stock.[30]

STATUS OF A NON-EXEMPT CO-OPERATIVE

The question now arises as to the status of farmers' co-operatives that do not meet the above requirements. Naturally they are not tax exempt but actually these non-exempt co-operatives do not pay much tax, since the portion of earnings properly distributed as patronage dividends are not taxed. Although there is no express provision for the exclusion of patronage dividends from the income of co-operatives, the treasury and the courts have interpreted the law as permitting co-operatives to exclude from their taxable income patronage dividends or refunds paid in accordance with a contractual or other definite obligation.[31] However, care must be taken here as in the case of exempt farmers' co-operatives that the patronage dividends are paid on the basis of business done with both members and nonmembers. An association which paid patronage dividends to members only, was not allowed to deduct amounts which it had made on business done with nonmembers, even though it distributed such amounts in the guise of patronage dividends to members.[32]

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[25] Mim. 3886, X-2 Cum. Bull. 164, 167 (1931).
[26] *Ibid.*
[27] *Ibid.*
[28] Int. Rev. Code § 101(12).
[29] *Ibid.*
[30] South Carolina Produce Ass'n v. Comm'r of Int. Rev., 50 F.2d 742 (4th Cir. 1931).
[31] G.C.M. 17895 1937-1 Cum. Bull. 56. Deduction is granted to purchasing co-operatives on the theory that such patronage dividends are rebates; it is granted to marketing co-operatives as an additional cost of goods sold.
[32] Farmers Union Co-operative Co. v. Comm'r of Int. Rev., 90 F.2d 488 (8th Cir. 1937).

Furthermore such non-exempt co-operatives must establish a prior agreement with its customers providing for the distribution of patronage dividends. There must be a legal obligation on the part of the association to return to its patrons the net proceeds. Such an obligation may arise from the association's articles of incorporation, its by-laws or by contract. Thus, where payment of patronage dividends is purely a matter within the discretion of the Board of Directors, such an association cannot deduct these dividends from taxable income even though actually paid.[33]

It should be pointed out that payment of patronage dividends does not require payment of actual cash. To qualify for the deduction of patronage dividends and still retain the cash for working capital and expansion, non-exempt co-operatives frequently distribute the earnings to patrons in forms other than cash; such as stock, script, and equity receipts.

Although the question of taxability of patronage dividends is not within the scope of this article, it should be mentioned that there are sound arguments pro and con. For an interesting discussion on this question see "Cooperatives and Income Tax Exemption."[34]

CONCLUSION

The main requirements for the exemption of farmers' co-operatives may be summarized as follows:

1. *Profits must be distributed although the retention of reserves required by state law or a reasonable reserve for any necessary purpose does not destroy the exemption.*
2. *Distribution of profits must be to both members and non-members.*
3. *Distribution must be on the basis of patrons' produce sold or purchases made.*
4. *Nonmember business may not exceed the value of products marketed for members in marketing co-operatives, and purchases may not exceed the value of supplies and equipment purchased for members in purchasing co-operatives providing such non-members are producers.*
5. *Substantially all of the stock must be owned by producers who market their product or purchase their supplies through the association.*
6. *Dividends on capital stock do not destroy the exemption as long as the dividend rate does not exceed the legal rate of interest in the state of incorporation or 8 per cent, whichever is greater.*

Farmers' co-operatives that do not meet all the above requirements can reduce their tax liability by payment of patronage dividends which may be excluded or deducted from income provided they are paid to both members and nonmembers in accordance with a contractual or other definite obligation.

Ludwik Kulas

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[33] American Box Shook Export Ass'n v. Comm'r of Int. Rev., 156 F.2d 629 (9th Cir. 1946).

[34] Note, 34 Va. L. Rev. 314 (1948).